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FTB Notice 91-2
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Re: Taxation of Contributions In Aid Of Construction

The Franchise Tax Board staff recently identified an area of nonconformity with federal law affecting the taxation of regulated public utilities. As explained in this notice, payments commonly referred to as contributions in aid of construction ("CIAC's") and as defined in federal administrative and judicial law, must be included in gross income of a recipient regulated public utility. Such payments are generally not contributions to the capital of a corporation.

An analysis of federal administration and court decisions dealing with the taxation of payments to a corporation is necessary to determine whether such payments represent contributions to capital, or are to be included in gross income.

Gross income of a corporation includes all income from whatever source derived. (Revenue & Taxation Code (R&TC) Section 24271; Internal Revenue Code (IRC) § 61.) Unless an item is specifically excluded from gross income, it is included in the measure of tax of a corporation.

Federal law provides statutorily for an exclusion from gross income for any contribution to the capital of a corporation. (IRC § 118.) California has never conformed statutorily to IRC § 118. However, in Legal Ruling 362, December 14, 1973, it was held that express statutory authority, like that found in IRC § 118, is not required to exclude a contribution to capital from gross income since, according to the federal legislative history of that section, it "merely restates the existing law as developed through administration and court decisions." (See S. Rept. No. 1662 and Conference Report No. 2543, which accompany the Internal Revenue Code of 1954, set forth at pp. 4648, 4793, and 4825, 3 U.S.C. Cong. & Admin. News (1954); 83d Cong. 2d Sess. 190 [1954].) That such federal common law has been adopted for California purposes is further evidenced by the 1955 conformity to basis rules which were adopted to augment the federal, judicially developed law dealing with contributions in aid of construction. (See R&TC Section 24554.)

The specific type payments at issue involve, typically, nonshareholder advances to fund an infrastructure expansion of a utility into developing areas of service need. As detailed below, in 1976 Congress deviated from the judicially developed general rule that such payments were to be included in gross income, and enacted IRC § 118(b) which

defined such payments, for federal purposes, as contributions to capital (IRC § 118(b)(1)), for which a special zero basis rule applied to property received by or acquired with such payments (IRC § 118(b)(4)). California law contains no counterpart to IRC § 118(b). [1]

To determine whether payments in the nature of CIAC's are, for California purposes, included in, or excluded from the gross income of a taxpayer, only the administration and court decisions which construe the term "contributions to capital" in relation to the specific type of payments at issue are authoritative. Federal administrative and judicial history relating to the taxation of nonshareholder payments to regulated public utilities, for periods prior to February 1, 1976, is set forth in Revenue Ruling 75-557, 1975-2 C.B. 33. (See, Teleservice Company of Wyoming Valley, 27 T.C. 772, *aff'd*, 254 F.2d 105 (3rd Cir. 1958, *cert. denied*, 357 U.S. 919 (1958); United States v. Chicago, Burlington and Quincy Railroad Co., 412 U.S. 401 (1973); Irving J. Hayutin, 31 TCM 509 (1973), *aff'd*, 508 F.2d 462 (10th Cir. 1975).) This line of authorities establishes the basis for the taxation of nonshareholder payments to a corporation, which authority serves as the basis for the continuing taxation of such payments, given the legislative history to California's nonconformity to the adoption of IRC § 118(b).

To summarize the authorities referenced in the ruling, and additional authorities, the tax consequences of payments made to a corporation are to be determined without distinction as to the status of the taxpayer as a regulated public utility. (Rev. Rul. 75-557, *supra.*) Payments made to a corporation by nonshareholders, or by others in a capacity other than as a shareholder, will be included in gross income to the extent such payments were essentially the price of the services

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[1/] In A Report Of The Task Force on California Conformity With The Federal Tax Reform Act Of 1976, as submitted to the Assembly Committee On Revenue And Taxation, Hon. Willie L. Brown, Jr., Chairman, dated January 28, 1977, it was recommended that California not conform to the federal statutory provision. The rationale for that recommendation was stated as follows: 06 Exempting income from taxation creates another tax expenditure or tax loophole. Construction aid contributions by nonshareholders are by traditional accounting/legal principles properly considered taxable income. (Emphasis added.)

obtained as a result of the payments. (U.S. v. Chicago, Burlington and Quincy Railroad Co., *supra.*; Hayutin, *supra.*; United Grocers, Ltd. v. United States, 61-2 USTC ¶ 9763 (9th Cir. 1962); Detroit Edison Co. v. Commissioner, 319 U.S. 98, 102, 87 L Ed 1286, 63 S Ct 902 (1943).)

Further, in determining whether a nonshareholder payment represents gross income or a contribution to capital, the primary focus of inquiry is the intent or motive of the transferor, which intent or motive will determine in the first instance whether the payments were essentially for services. If it is determined that such payments were not essentially for services, the tax characteristics of a particular transaction will be based on facts and circumstances existing at the time of payment. (Chicago, Burlington and Quincy Railroad Co., 412 U.S., at 411, 37 L.Ed.2d 30.; Appeal of Desert Hot Springs Water Co., Cal. St. Bd. of Equal., May 20, 1959.)

With regard to the basis of assets acquired in these transactions, to the extent a transferee is taxable, the assets acquire a cost basis. To the extent a nonshareholder transfer is a contribution to capital, R&TC Sections 24552 and 24554 provide a zero basis rule as specified. (See also, Treas. Reg. § 1.118-1; IRC §§ 362(a) and (c); see also, Chicago, Burlington and Quincy Railroad Co., 412 U.S. at 413.)

In response to Rev. Rul. 75-557, the federal legislation noted above was adopted, effective as to payments received on or after February 1, 1976. Payments which were defined as CIAC's and made to certain regulated public utilities were classified as contributions to capital. (IRC § 118(b).) (See Committee Reports on P.L. 94-455 and P.L. 95-600.) California never conformed to that legislation, so the statutory classifications were never applicable for California tax purposes. As a result, California law, as set forth above, continued to apply to payments received by regulated public utilities after February 1, 1976, and such payments typically continued to be included in gross income. (See fn. 1, above.)

In TRA 1986, Congress reversed its position and CIAC's were specifically subjected to federal income taxation effective as to contributions received after December 31, 1986. (IRC § 118(b).) California never conformed to the 1986 federal statutory provisions. Thus, California law, as set forth above, continues to apply to payments received by regulated public utilities after December 31,

1986, and will generally result in the same taxable income as results under federal statutory law after 1986.

DRAFTING INFORMATION

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